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EXPOSURE DRAFT

**PROPOSED STATEMENT ON
AUDITING STANDARDS**

**THE COMMUNICATION OF
CONTROL-STRUCTURE RELATED MATTERS
NOTED IN AN AUDIT**

FEBRUARY 14, 1987

Prepared by the AICPA Auditing Standards Board
For comment from persons interested in auditing and reporting

Comments should be received by July 15, 1987, and addressed to
AICPA Auditing Standards Division, File 4285
1211 Avenue of the Americas, New York, N.Y. 10036-8775

SUMMARY

Why Issued

Management, audit committees, and others responsible for internal control in an entity have indicated that they have difficulty understanding the auditor's report on material weaknesses in internal control identified in a financial statement audit. These users, and many auditors, also have indicated that the concept of a material weakness in internal control is ambiguous and, therefore, difficult to apply in practice. They also believe that because the concept relates only to material misstatements of financial statements, some significant internal control deficiencies may not be reported. This proposed statement on auditing standards would clarify report language and replace the concept of material weakness in internal control with a broader, more operational concept of reportable internal control conditions.

What It Does

This Statement supersedes SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, and sections of SAS No. 30, *Reporting on Internal Accounting Control*.

Specifically, the Statement—

- Defines a *reportable condition* as significant deficiencies in the design or functioning of the control structure that could adversely affect the entity's ability to report financial data consistent with financial statement assertions.
- Requires the auditor to communicate reportable conditions observed in an audit to the audit committee or its equivalent.
- Permits communication of reportable conditions to be made orally or in writing.
- Establishes report language requirements when communications are made in writing and provides examples of reports.
- Recognizes that agreed-upon criteria may be established for reporting matters other than those that meet the definition of a reportable condition.

How It Differs From Existing Standards

This Statement—

- Replaces the concept of *material weaknesses* with the concept of *reportable conditions* when reporting on internal control as part of a financial statement audit.
- Changes the guidance for communications made in writing by—
 1. Deleting the reference to the limited purpose of a study and evaluation of internal control in an audit.
 2. Deleting the disclaimer of an opinion on the system of internal control taken as a whole.

This exposure draft has been sent to—

- *Practice offices of CPA firms.*
 - *Members of AICPA Council and technical committees.*
 - *State society and chapter presidents, directors, and committee chairmen.*
 - *Organizations concerned with regulatory, supervisory, or other public disclosure of financial activities.*
 - *Persons who have requested copies.*
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American Institute of Certified Public Accountants

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February 14, 1987

Accompanying this letter is an exposure draft of a proposed statement on auditing standards titled The Communication of Control-Structure Related Matters Noted in an Audit. This Statement would supersede SAS No. 20, Required Communication of Material Weaknesses in Internal Accounting Control and paragraphs 47 through 53 of SAS No. 30, Reporting on Internal Accounting Control.

This Statement is being proposed to address two problems concerning the auditor's responsibility to report material weaknesses in internal control identified in a financial statement audit. First, audit committees and other report users have indicated that the report language is difficult to understand. Second, these users, and some auditors, have indicated that the concept of a material weakness in internal control is ambiguous and difficult to use in practice. They also believe that because the concept is related solely to material misstatements of financial statements it may exclude significant internal control deficiencies that should be reported.

SAS No. 20 requires the auditor to communicate to senior management and the Board of Directors or its audit committee material weaknesses in internal control identified during a financial statement audit. That SAS permits the communication to be either oral or written. When a written communication is used, paragraphs 47 through 53 of SAS No. 30 apply. Those paragraphs require that the auditor's report (1) indicate that it is for restricted use, (2) describe the limited purpose of a study and evaluation of internal control in a financial statement audit, and (3) disclaim an opinion on the system of internal control taken as a whole.

The proposed Statement modifies these reporting requirements to improve the clarity of the report language. The proposed Statement retains the requirement that the report indicate that it is for restricted use. However, the proposed Statement neither requires nor suggests that the report contain a description of the limited purpose of a study and evaluation of internal control or a disclaimer of opinion.

Both SAS Nos. 20 and 30 define a material weakness in internal control as a condition in which the specific control procedures, or the degree of compliance with them, results in more than a relatively low risk that errors or irregularities in amounts that would be material in relation to the audited financial statements may occur and not be detected. Because this definition refers only to specific control procedures, it is unclear whether it is intended to include control environment and accounting system deficiencies. In addition, because the definition relates solely to material misstatements of financial statements, it may exclude other significant control deficiencies that should be reported.

To overcome these two problems, the proposed Statement replaces the concept of material weakness with the concept of reportable condition. A reportable condition relates to significant deficiencies in the design or functioning of the entity's control structure (control environment, accounting system, and control procedures) that could adversely affect the entity's ability to record, process, summarize, and report financial data consistent with management's assertions in the financial statements. This concept, therefore,

includes the control environment and the accounting system as well as control procedures. It also is not limited solely to deficiencies regarding material amounts in the financial statements. The Appendix to the proposed Statement provides examples of reportable conditions.

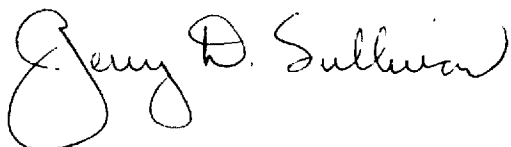
The proposed Statement substitutes the reportable condition concept for the material weakness concept only for communications that are based solely on the work done in a financial statement audit. Other engagements to report on an entity's system of internal control are not affected by the proposed Statement.

Comments or suggestions on any aspect of this exposure draft will be appreciated. The Auditing Standards Board's consideration of responses will be helped if the comments refer to specific paragraphs and include supporting reasons for each suggestion or comment.

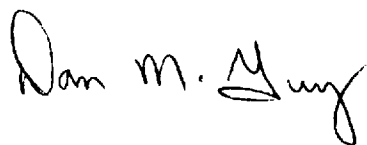
In developing guidance, the Auditing Standards Board considers the relationship between the cost imposed and the benefits reasonably expected to be derived from audits. It also considers differences that the auditor may encounter in the audit of the financial statements of small businesses and, when appropriate, makes special provisions to meet those needs. Thus, the board would particularly appreciate comments on those matters.

Written comments on the exposure draft will become part of the public record of the Auditing Standards Division and will be available for public inspection at the offices of the AICPA after August 17, 1987, for one year. Responses should be sent to the AICPA Auditing Standards Division, File 4285, in time to be received by July 15, 1987. For convenience in responding, a perforated response form is attached and a postpaid return envelope is provided with this exposure draft.

Sincerely,

A handwritten signature in cursive script that reads "Jerry D. Sullivan".

Jerry D. Sullivan
Chairman
Auditing Standards Board

A handwritten signature in cursive script that reads "Dan M. Guy".

Dan M. Guy
Vice President, Auditing

PROPOSED STATEMENT ON AUDITING STANDARDS

THE COMMUNICATION OF CONTROL-STRUCTURE RELATED MATTERS NOTED IN AN AUDIT

1. This Statement provides guidance in identifying and reporting conditions observed during an audit relating to an entity's control structure. It is contemplated that the communication would generally be to the audit committee or to individuals with a level of authority and responsibility equivalent to an audit committee in organizations that do not have one, such as the board of directors, the board of trustees, an owner in an owner-managed enterprise, or others who may have engaged the auditor. For the purpose of this Statement, the term *audit committee* will be used to refer to the appropriate recipient of the communication. This Statement also provides guidance on establishing, between the auditor and client, agreed-upon criteria for identifying and reporting additional matters beyond those established as required by this Statement.

REPORTABLE CONDITIONS

2. In the course of an audit, the auditor often becomes aware of matters relating to the control structure that should be of interest to the audit committee.¹ The matters that this Statement requires for reporting to the audit committee are referred to as *reportable conditions*.² Specifically, these are matters coming to the auditor's attention that in his judgment represent significant deficiencies in the design or functioning of

the control structure, that could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. Such deficiencies may involve aspects of (a) the control environment, (b) the accounting system, or (c) specific control procedures. (See the Appendix for examples of reportable conditions.) Some of the items noted by the auditor may not meet the test of reportable conditions as defined; however, the auditor may choose to communicate such matters for the benefit of management.

3. The auditor's objective in the audit of financial statements is to form an opinion on the entity's financial statements as a whole. The auditor may become aware of possible reportable conditions through consideration of aspects of the control structure (see the proposed statement on auditing standards *The Auditor's Responsibility for Assessing Control Risk*), application of audit procedures to balances and transactions, or otherwise during the course of the audit. The auditor's awareness of reportable conditions will vary with each audit and will be influenced by the nature and extent of audit procedures and numerous other factors, such as an entity's size, its complexity, and the nature and diversity of its business activities.

4. While conducting an examination in accordance with generally accepted auditing standards, the auditor may become aware of matters relating to the control structure; however, the auditor's obligation to communicate control-structure related matters is incident to the audit and is limited to those matters noted that in the auditor's judgment are to be deemed reportable conditions.

5. Whether matters noted should be considered sufficiently significant to be reported under this

Statement is a matter of the auditor's judgment. In making this judgment, the auditor should take into consideration various factors relating to the entity, such as its size, complexity and diversity of activities, organizational structure, and ownership characteristics.

6. The existence of reportable conditions related to control-structure design may already be known, and in fact may represent a conscious decision by management—a decision of which the audit committee is aware—to accept that degree of risk for cost or other considerations. It is the responsibility of management to make the decisions concerning costs to be incurred and related benefits. Provided the audit committee has acknowledged its understanding and consideration of such deficiencies and the associated risks, the auditor may decide that the matter need not be reported. In such circumstances it would be inappropriate to report that there are no reportable conditions such as included in the examples in paragraph 14.

AGREED-UPON CRITERIA

7. The auditor and client may discuss the control structure and concerns over its functioning in making arrangements for the audit. Clients may request the auditor to be alert to matters and to report conditions that go beyond those contemplated by this Statement. The auditor is not precluded from reporting matters he views to be of value to management in the absence of any specific request to do so.

8. Agreed-upon arrangements between the auditor and the client to report conditions noted may include, for example, the reporting of matters of less significance than provided for by this Statement, the existence of conditions specified by the client, or the results of further investigation of matters noted to identify underlying

¹ The auditor should also include or consider matters coming to his attention relating to interim reporting outside the entity in the communication contemplated by this Statement.

² The concept of *reportable conditions* will replace *material weaknesses* when reporting on internal accounting control is based solely on a study and evaluation made as part of an audit. Engagements to report on an entity's system of internal accounting control are not affected. Accordingly, this Statement supersedes SAS No. 20, *Required Communication of Material Weaknesses in Internal Accounting Control*, SAS No. 30, *Reporting on Internal Accounting Control*, paragraphs 47 through 53, and amends or supersedes auditing interpretations of related SASs.

causes. Under these arrangements, it is possible that the auditor will be requested to visit specific locations, assess specific control procedures, or undertake specific auditing procedures not otherwise planned.

REPORTING—FORM AND CONTENT

9. Conditions noted by the auditor that are considered reportable under this Statement or that are the result of agreement with the client preferably should be reported in writing. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.

10. The report should include an appropriate caveat that the communication is intended solely for the information and use of the audit committee, management, and others in the organization. When there are requirements established by governmental authorities to furnish such reports, specific reference to such regulatory authorities may be made.

11. The following is an illustration of the sections of a report encompassing the above considerations.

In connection with our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we noted certain matters involving the control structure and its functioning that we consider to be reportable conditions under standards established by the American Institute of Certified Public Accountants. Reportable conditions involve matters coming to our attention relating to significant deficiencies in the design or functioning of the control structure that in our judgment could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. These may involve aspects of (a) the control environment, (b) the accounting system, or (c) specific control procedures.

[Include paragraph to describe the reportable conditions noted.]

This report is intended solely for the information and use of the audit com-

mittee (board of directors, board of trustees, or owners in owner-managed enterprises), management, and others in the organization.

12. If the auditor has observed no matters considered to be reportable conditions as defined, and wishes to communicate that fact, the communication should include the definition of reportable conditions. Any such communication should also indicate only that no reportable conditions were observed and should not represent that there are no reportable conditions.

13. In a communication that contains both observations that are deemed by the auditor to be reportable conditions, as defined, and other comments, it may be appropriate to indicate which comments are in each category.

14. The following are examples of paragraphs that may be used to communicate in the indicated set of circumstances:

a. No reportable conditions were observed and no representation is made that none were observed, but other comments are being furnished for the benefit of management, the audit committee, or both.

In connection with our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, certain matters came to our attention. This report contains for your consideration our comments and recommendations regarding such matters.

[The definition of reportable conditions need not be included so long as there were none observed and there is no reference to the term.]

[Include the final paragraph in the report illustrated in paragraph 11.]

b. No reportable conditions were observed but other comments are being made and a representation is being made that no reportable conditions were observed.

[Same first two sentences as explained in a.] Under standards

established by the American Institute of Certified Public Accountants we are required to communicate matters to you involving the control structure and its functioning that we consider to be reportable conditions. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or functioning of the control structure that in our judgment could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

These may involve aspects of (a) the control environment, (b) the accounting system, or (c) specific control procedures.

None of the matters observed by us and communicated in this report are deemed to be reportable conditions.

[Include the final paragraph in the report illustrated in paragraph 11.]

c. Representation is being made that no reportable conditions were noted and no other comments are being furnished.

This report is to advise you that in connection with our audit of the financial statements of the ABC Corporation for the year ended December 31, 19XX, we noted no matters relating to the control structure or its functioning that we consider to be reportable conditions under the standards established by the American Institute of Certified Public Accountants. Reportable conditions are matters coming to our attention relating to significant deficiencies in the design or functioning of the control structure that in our judgment could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements. These may involve aspects of (a) the control environment, (b) the accounting system, or (c) specific control procedures.

[Include the final paragraph in the report illustrated in paragraph 11.]

15. Because timely communication of the significant matters noted is important, the auditor may choose to communicate during the course of

the audit rather than after the audit is concluded and the report on financial statements has been issued. The decision on whether an interim communication should be issued would be influenced by the relative significance of the matters noted and the

urgency of corrective follow-up action.

16. The provisions in this Statement should not be viewed as precluding an auditor from communicating to a client a variety of observa-

tions and suggestions regarding its activities that go beyond control-structure matters. Such matters may deal with operational or administrative efficiencies, business strategies, and other items of perceived benefit to the client.

APPENDIX

EXAMPLES OF POSSIBLE REPORTABLE CONDITIONS

1. As indicated in paragraph 2 of this Statement, reportable conditions involve matters coming to the auditor's attention relating to significant deficiencies in the design or functioning of the control structure that in the auditor's judgment, either individually or in the aggregate, could adversely affect the organization's ability to record, process, summarize, and report financial data consistent with the assertions of management in the financial statements.

2. The following are examples of matters that may be reportable conditions. They are grouped by categories of conditions and within categories by specific examples of conditions. Certain of the matters may also require communications under the provisions of other statements on auditing standards.

Deficiencies in control-structure design:

- Inadequate overall control-structure design
- Absence of appropriate segregation of duties consistent with appropriate control objectives
- Absence of appropriate reviews and approvals of transactions,

accounting entries, or systems output

- Inadequate procedures for appropriately assessing and applying accounting principles
- Absence of other control techniques considered appropriate for the type and level of transaction activity
- Evidence that a system fails to provide complete and accurate output consistent with objectives and current needs because of design flaws

Failures in the functioning of the control structure:

- Evidence of failure of identified controls in preventing or detecting misstatements of accounting information
- Evidence that a system fails to provide complete and accurate output consistent with the entity's control objectives because of the misapplication of control procedures

Performance failures:

- Evidence of intentional override of the control system by those in authority to the detriment of the overall objectives of the system

- Evidence of failure to perform tasks that are part of the control structure, such as reconciliations not prepared or not timely prepared
- Evidence of willful wrongdoing by employees or management
- Evidence of manipulation, falsification, or alteration of accounting records or supporting documents
- Evidence of intentional misapplication of accounting principles
- Evidence of misrepresentation by client personnel to the auditor
- Evidence that employees or management lack the qualifications and training to fulfill their assigned functions

Other audit findings indicative of control-related deficiencies:

- Absence of a sufficient level of control consciousness within the organization
- Failure to follow up and correct previously identified control-structure deficiencies
- Evidence of significant or extensive undisclosed related party transactions
- Evidence of undue bias or lack of objectivity by those responsible for accounting decisions

Response Form Follows

